

THE REALITY OF RECAPTURE

EXPLAINING THE HISTORY AND REMOVING THE MYSTERY BEHIND THE FEDERAL RECAPTURE TAX

Some home buyers, builders, Realtors® and mortgage lenders who want to use the Michigan State Housing Development Authority's low interest rate loans are concerned about the federal "recapture tax." This simple explanation may alleviate those needless worries and help more people who could benefit from our Mortgage Revenue Bond (MRB) and Mortgage Credit Certificate (MCC) programs.

EXPLAINING ITS HISTORY

A federal law commonly known as "recapture tax" applies to borrowers who buy their homes using MRBs and MCCs like those issued by the Michigan State Housing Development Authority (MSHDA). Recapture tax requires some borrowers to repay the government a portion of their gain upon the sale of the home if they financed their home with an MRB or MCC loan. The Internal Revenue Service (IRS) administers this provision. If any recapture tax is due, the borrower pays it to the IRS after selling the home. At MRB and MCC loan closings, MSHDA provides a "Recapture Requirement" form showing the maximum recapture tax which could be due, if any.

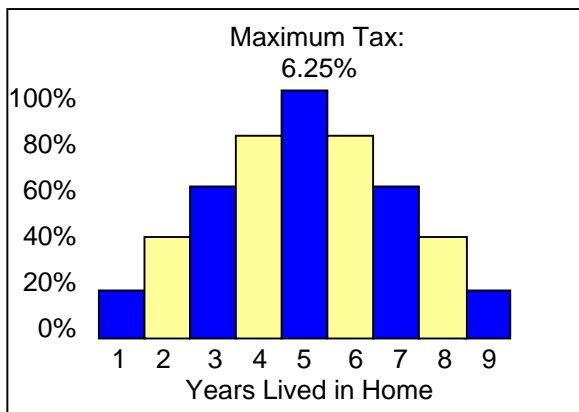
REMOVING THE MYSTERY

In reality, most borrowers will not have to pay any recapture tax. For others, the amount will be minimal. In any case, the tax will never exceed one-half of the gain on the sale of the home, or 6.25% of the original mortgage, whichever is less.

This may sound complicated, but in many cases, no tax is due. For example:

- If your household income does not rise significantly over the life of the loan (generally more than 5 percent per year), there is no recapture.
- If you sell your home anytime after nine years, there is no recapture.
- If you sell your home within nine years but there is no gain, there is no recapture.

In other words, to owe any recapture tax at all, you must sell your home within nine years, earn significantly more income than when you bought the home, **and** gain from the sale. All three of these criteria must be met.



The basis of recapture is this: Borrowers will never pay more than 6.25 percent of the original loan amount and usually will pay less, if they pay at all. Recapture taxes are figured on a scale based on the number of years the homebuyer has lived in the house, with the fifth year being the worst time to sell (see chart).

The maximum recapture tax due is only 6.25 percent in five years of homeownership.

But that's not the end of the story...the tax guidelines are structured to help borrowers even if they do have to pay.

- The 5 percent increase in income that makes a borrower a candidate for recapture is figured from the maximum federal income limit for the MRB and MCC programs at the time of purchase. For example, Fred earned \$40,000 per year when he purchased his home. At the time, the maximum income limit was \$50,000. The 5 percent increase would be figured from the \$50,000, not \$40,000. Fred would actually have to receive more than a 5 percent increase in salary each year to be considered for recapture.
- Recapture tax may not exceed 50 percent of the gain the borrower realizes upon the sale of the home. Even if Fred sold his home in year five, his income increased significantly, and he made \$2,000 off the sale, the maximum he could owe is \$1,000. And the gain is calculated **after** items such as Realtor, legal and closing fees are subtracted.
- If the borrower's income exceeds the maximum income limit, but not by more than \$5,000, only a percentage of the tax must be paid.

When the program serves those it's intended for, recapture is seldom a threat. For most people, the financial benefits of homeownership – deductions for mortgage interest and taxes as well as the MRB and MCC programs' benefits – far outweigh the risks of recapture.

ADDITIONAL ANSWERS

Will recapture eliminate a borrower's gain from the sale of the home?

Fortunately, no. The recapture tax can never exceed 50% of the gain.

What happens if the loan is assumed?

If the sale or transfer occurs within the first nine years of ownership, the original borrower pays the recapture tax that would normally be due and a new nine-year period begins for the purpose of applying a new recapture tax to the assuming purchaser.

How does the IRS track the amount of the recapture tax due?

MSHDA is required to report to the IRS the name, address and Social Security numbers of all recipients of MSHDA and MCC loans. The borrower is required to file IRS Form 8828 with his/her federal income tax return for the tax year in which the home is sold or transferred.

Is recapture tax due if the borrower dies within the nine-year period?

No. A death transfer is not a sale or transfer for the purposes of recapture tax.

What if the home is destroyed as a result of fire, flood or other natural disaster?

If the home is destroyed and the borrower rebuilds on the same site within two years after the year in which the insurance proceeds are received, no recapture tax is due at that time.

For more information consult a tax professional or contact
Michigan State Housing Development Authority
1-800-327-9158 • (517) 373-6840

(TTY) 1-800-382-4568

www.michigan.gov/mshda

Equal Housing Lender



6/04